

The University of Tennessee

**For the Year Ended
June 30, 1998**

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February 10, 1999

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable William B. Sansom, Chairman
Finance Committee
Board of Trustees
The University of Tennessee
Knoxville, Tennessee 37996-0180
and
Dr. Joseph Johnson, President
The University of Tennessee
831 Andy Holt Tower
Knoxville, Tennessee 37996-0180

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the University of Tennessee for the year ended June 30, 1998. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The university's administration has responded to the audit findings; the responses are included following each finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/sdr
98/090

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
The University of Tennessee
For the Year Ended June 30, 1998

AUDIT OBJECTIVES

The objectives of the audit were to consider the university's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, contracts, and grants; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

INTERNAL CONTROL FINDINGS

Contracts Not Approved Before Beginning of the Contract Period*

The university allowed services to be rendered before proper university approvals were obtained. If contracts are not approved before services are rendered, the university could be obligated to pay for unauthorized services (page 9).

Campus-Level Review of Sole-Source Contracts May Not Be Sufficient

The university's reasons for sole-source procurement of services has not always been clearly identified and well documented. A listing of sole-source contract approvals should periodically be forwarded to the Vice President for Business and Finance for review (page 12).

Failure to Follow Purchasing Procedures

Purchasing department personnel systemwide did not fully comply with the university's established purchasing procedures concerning informal competitive price quotations and sole-source purchases (page 13).

Failure to Recalculate Certain Pell Awards and to Monitor Withdrawals

The University of Tennessee at Knoxville and the University of Tennessee at Memphis do not recalculate federal Pell Grant awards to students who fail to begin attending some of their classes. In addition, the University of Tennessee at Knoxville does not monitor the class attendance of financial aid recipients for evidence of unofficial withdrawal (page 10).

COMPLIANCE FINDING

Failure to Promptly Return Financial Aid Refunds

The University of Tennessee at Chattanooga and the University of Tennessee at Memphis did not always return the federal financial aid portion of refunds to lending institutions in a timely manner. In addition, the University of Tennessee at Memphis did not always follow federal regulations for the timely crediting of refunds to student financial aid programs (page 11).

* This finding is repeated from the prior audit.

OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report which contains all findings, recommendations, and management comments, please contact

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 741-3697

Audit Report
The University of Tennessee
For the Year Ended June 30, 1998

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The University of Tennessee For the Year Ended June 30, 1998

INTRODUCTION

POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the University of Tennessee. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any state governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

The University of Tennessee was first established as Blount College in 1794 by the legislature of the Federal Territory. In 1807, the General Assembly renamed the institution East Tennessee College and in 1840 designated it a university. East Tennessee University was selected by the General Assembly to be Tennessee’s land-grant institution under the terms of the Morrill Act of 1862. In 1879, the General Assembly chose the school to be Tennessee’s state university and changed the name to the University of Tennessee.

Since its establishment, the university has grown into an institution with 23 different colleges and schools. With its primary campuses, various experiment stations, and extension services, the university provides services throughout the state. The main campus is in Knoxville; other campuses are in Memphis, Martin, and Chattanooga.

ORGANIZATION

The University of Tennessee is governed by the University of Tennessee Board of Trustees. In 1968, the board reorganized the institution into a university system, giving a central administrative staff the responsibility for the entire operation of the university and establishing on the primary campuses chancellors who are responsible for their respective campuses.

AUDIT SCOPE

The audit was limited to the period July 1, 1997, through June 30, 1998, and was conducted in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 1998, and for comparative purposes, the year ended June 30, 1997. The University of Tennessee is an integral part of state government. As such, it has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the university's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;
2. to determine compliance with certain provisions of laws, regulations, contracts, and grants;
3. to determine the fairness of the presentation of the financial statements; and
4. to recommend appropriate actions to correct any deficiencies.

Although this audit was not intended to serve as an organization-wide audit as described in the Single Audit Act, as amended by the Single Audit Act Amendments of 1996, and Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," it included tests of compliance with applicable federal laws and regulations and consideration of internal control used in administering federal financial assistance programs. This audit is a segment of the organization-wide audit of the State of Tennessee, which is conducted in accordance with the Single Audit Act.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The university filed its report with the Department of Audit on June 17, 1998. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the university has corrected a previous audit finding concerning UT Martin's failure to promptly report enrollment status changes of loan recipients.

REPEATED AUDIT FINDINGS

The prior audit report also contained findings concerning the failure to properly approve contracts and the failure at UT Knoxville to recalculate Pell awards when students do not begin attending classes. These findings have not been resolved and are repeated in this report.

OBSERVATIONS AND COMMENTS

FOLLETT CAMPUS RESOURCES

On August 26, 1998, the Audit and Management Services Office of the University of Tennessee at Knoxville (UTK) released a special review of allegations concerning book buybacks. Buyers at the UTK Book and Supply Store were allegedly paying less than the established prices for used books. As noted in the special review report, the buyers were employees of Follett Campus Resources, a company that had been buying back books at the end of the major school terms for many years. The report concluded that the underpayments were intentional and caused the UTK bookstore to pay more than cost for some used books—a violation of the bookstore's agreement with Follett Campus Resources.

The report estimated that underpayments since December 1989 totaled \$280,939.71 based on statements of employees of UTK bookstore and Follett Campus Resources. According to the report, the underpayments were apparently a procedure used by a particular group of buyers, not a practice of Follett Campus Resources. The report further stated that it did not appear that Follett Campus Resources was aware of the underpayments or benefited from them. In addition,

the report concluded that there was no evidence to suggest that management of the UTK bookstore had knowledge of the underpayments or that any UTK bookstore employees benefited from the underpayments.

Recognizing that an exact calculation of the underpayments was not possible, the University of Tennessee and Follett Campus Resources management negotiated a \$380,000 payment to the University of Tennessee for the estimated underpayments and other claims since December 1989.

Examination of the book buyback process and the method of discovery of the underpayments disclosed five weaknesses: (1) the book buyback process was not governed by written contract provisions; (2) UTK bookstore management and employees did not formally and systematically monitor the purchasing activities of Follett Campus Resources buyers; (3) the Follett Campus Resources buyers were not required to use a record and receipt system to document the cash disbursed or to provide written receipts of individual transactions; (4) the retail and wholesale prices for used books were not posted or otherwise available to students at all book buyback locations; and (5) UTK bookstore management did not promptly notify Audit and Management Services of suspected improprieties.

The Office of Audit and Management Services will perform necessary follow-up procedures.

RIVER CITY CLASSIC

On July 22, 1998, the Audit and Management Services Office of the University of Tennessee at Chattanooga released a special review of revenues for the River City Classic football game between UT Chattanooga and Tennessee State University. The game was played on October 18, 1997, at Finley Stadium in Chattanooga. It was the first game played at Finley Stadium, a new facility.

According to the report, the University of Tennessee at Chattanooga did not maintain sufficient control over game-day ticket sales. Several problems were noted. No record was kept of tickets issued to each cashier or cash collected from each cashier. There was no documentation of tickets sold for less than face value. There was no final reconciliation between tickets issued, the cash collected, and unused tickets. Proceeds from game-day ticket sales were not deposited in a timely manner in accordance with university *Fiscal Policy*. Adequate records were not maintained to support complimentary tickets issued on the day of the game. Documentation for some of the complimentary tickets issued did not include necessary signatures of authorization.

A computerized ticketing system has since been implemented at Finley Stadium. Proper reconciliation procedures have been instituted. Controls over complimentary tickets have also been improved.

The Office of Audit and Management Services will perform necessary follow-up procedures.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the university's financial statements for the year ended June 30, 1998, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Reportable conditions, along with recommendations and management's responses, are detailed in the findings and recommendations. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance

The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. Immaterial instances of noncompliance, along with recommendations and management's responses, are included in the findings and recommendations.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the university's financial statements.

**Report on Compliance and on Internal Control
Over Financial Reporting Based on an Audit of
Financial Statements Performed in Accordance With
*Government Auditing Standards***

September 25, 1998

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the financial statements of the University of Tennessee, which is a component unit of the State of Tennessee, as of and for the year ended June 30, 1998, and have issued our report thereon dated September 25, 1998. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the university's financial statements are free of material misstatement, we performed tests of the university's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We did, however, note certain immaterial instances of noncompliance that we have included in the Findings and Recommendations section of this report. We also noted certain other less significant instances of noncompliance that we have reported to the university's management in a separate letter.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the university's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the university's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

The following reportable conditions were noted:

- Contracts were not approved before the beginning of the contract period.
- Class attendance was not monitored to determine if financial aid recipients had unofficially withdrawn or had not begun attending their classes.
- Campus-level approval of sole-source contracts may not be sufficient.
- Purchasing department personnel failed to follow the university's purchasing procedures.

These conditions are described in the Findings and Recommendations section of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

The Honorable W. R. Snodgrass
September 25, 1998
Page Three

We also noted other matters involving the internal control over financial reporting, which we have reported to the university's management in a separate letter.

This report is intended for the information of the General Assembly of the State of Tennessee and management. However, this report is a matter of public record, and its distribution is not limited.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/sdr

FINDINGS AND RECOMMENDATIONS

1. Contracts were not approved before the beginning of the contract period

Finding

As noted in the previous audit, the university allowed services to be rendered before proper university approvals were obtained. Fourteen of 21 contracts reviewed (67%) were not approved before the beginning of the contract period, and the approval was not obtained until four to 412 days after the beginning of the contract period. The university's *Fiscal Policy*, Statement 5, Section 130, Part 4, states that contracts "must be executed by a Vice President unless authority to sign for the specific type of contract is delegated to specific campus, institute, or unit officials." Additionally, the university's bylaws state that the university is not legally bound to the contract until the contract is approved by proper university personnel. If contracts are not approved before the contract period begins and before services are rendered, the university could be obligated to pay for unauthorized services.

In the prior audit, management stated, "The university recently changed its contracting policies by delegating the authority to execute most contracts under a specified contract amount to senior campus level administrators. This change reduces the execution time for many university contracts and will help address the weaknesses noted in this finding. In addition, the university will communicate to campus leadership the importance of processing contracts prior to the beginning dates of the contracts." Although management did change the *Fiscal Policy* to delegate contract authorization to campus officials, contracts were still not approved before the contract period.

Recommendation

University management should take steps to ensure that all departments know and follow the fiscal policies pertaining to contracts. The contract process should be initiated far enough in advance to allow the contract to go through the proper channels. Contracts should be approved by proper university personnel before the beginning of the contract period. Procedures should include regular monitoring of the contracting process by supervisory staff to ensure compliance.

Management's Comment

The university concurs with the finding and recommendation but wishes to point out that no University funds are expended until a properly executed contract is on file supporting the expenditures. As pointed out previously, the University has delegated the authority to execute most contracts to senior campus level administrators, thereby expediting contract execution. While this procedural change has helped, additional review and communication is needed. The University will address this weakness by: 1) reviewing its contract data base to identify and work with these departments that are having trouble with timely contract execution; 2) review the type

of contracts that are repeatedly executed after the contract period begins to evaluate alternative encumbrance and disbursement procedures; and 3) communicate with campus/budget entity leadership the University's fiscal policy on timely contract execution and the necessity for compliance.

2. Class attendance was not monitored to determine if financial aid recipients had unofficially withdrawn or had not begun attending classes

Finding

The University of Tennessee at Knoxville does not monitor class attendance for evidence of unofficial withdrawals or failure to begin attending classes. As a result, the university does not process refunds or recalculate Pell awards for Title IV recipients who cease attending all or a portion of their classes. The *1997-1998 Student Financial Aid Handbook*, chapter 3, page 87, states, "Participating SFA [Student Financial Aid] schools are expected to monitor student attendance for the purpose of determining a withdrawal date in the case of unofficial withdrawal." Additionally, chapter 4, page 66, states, "If the student does not begin attendance in all of his or her classes, the school must recalculate the student's [Pell] award based on the lower enrollment status."

In addition, the University of Tennessee at Memphis does not recalculate federal Pell awards to students who fail to begin attending some of their classes. The unofficial withdrawal of student financial aid recipients from all classes is monitored; however, those who fail to begin attending a portion of their classes are not detected through this procedure.

The absence of a procedure to monitor financial aid recipients for unofficial withdrawal or to determine if Pell recipients fail to begin attending each of their classes could result in an overaward to some recipients or in a failure to make necessary refunds.

Recommendation

The University of Tennessee at Knoxville, through the registrar's office and the student financial aid office, should develop and implement procedures to monitor unofficial withdrawal and to determine if Pell recipients begin attending each registered class. Refunds and repayments should be made whenever the university determines a financial aid recipient has unofficially withdrawn, and Pell awards should be recalculated whenever a Pell recipient fails to begin attending each class.

At the University of Tennessee at Memphis, the financial aid office should develop and implement a procedure to determine if Pell recipients begin attending all classes. Pell awards should be recalculated whenever a student fails to begin attending each class.

Management's Comment

The University concurs with the finding. For the Knoxville campus beginning Fall semester 1999, attendance at the first day of class will be reported, and a second verification of attendance will be made on the corrected 14 day class rolls. At the end of the semester, a final check on student attendance will be made with the grade of FX, which is available for faculty to use on grade reports to identify students who never attended class. Students receiving financial aid under Title IV who are identified through these checks as not attending class will be contacted for repayment of loans when their lack of attendance changes their registration status.

The Memphis campus financial aid office has developed a process in which each Pell recipient will be given a document at the beginning of the semester which will record the instructor's certification that the Pell recipients began attending each class. Financial aid already has a module in the financial aid system which can produce, track and follow up the certification process. By using this process financial aid expects to be able to recalculate awards more readily.

3. The University of Tennessee failed to promptly return financial aid refunds

Finding

The bursar's office at the University of Tennessee at Memphis and the financial aid office at the University of Tennessee at Chattanooga did not return the federal financial aid portion of refunds to the appropriate programs or lending institutions in a timely manner. The *Code of Federal Regulations*, Section 34, Part 668.22 (h)(2)(iv), states:

The amount of the Title IV, HEA [Higher Education Act of 1965] program portion of the refund allocated to the Title IV, HEA programs other than the FWS, Federal Stafford Loan, Federal PLUS, and Federal SLS programs must be returned to the appropriate program account or accounts by the institution within 30 days of the date that the student officially withdraws, is expelled, or the institution determines that a student has unofficially withdrawn.

Concerning refunds to lenders, the *Code of Federal Regulations*, Section 34, Part 682.607 (c)(1) states, "A school shall pay a refund that is due within 60 days of the date that the student officially withdraws, is expelled, or the institution determines that a student has unofficially withdrawn." Nine of 19 refunds tested at UT Memphis (47%) were not returned to the appropriate program or lender within the required 30 or 60 days. In fact, in six cases, university personnel had not calculated the necessary refund. Three of eight Federal Family Education Loan refunds tested at UT Chattanooga (38%) were not returned to the lender within 60 days. The three loans were returned from 11 to 19 days late.

Recommendation

The bursar's office at UT Memphis and the financial aid office at UT Chattanooga should return the federal financial aid portion of refunds to the appropriate programs or lending institutions within the time frame specified by federal regulations.

Management's Comment

The university concurs with the finding. The Bursar's Office at UT Memphis and UT Chattanooga will establish procedures to return the Federal financial aid portion of refunds to the appropriate programs or lending institutions within the timeframe specified by Federal regulations.

4. Campus-level review of sole-source contracts may not be sufficient

Finding

During fiscal year 1998, the University of Tennessee contracted with a state agency to provide certain services. Subsequently, the university subcontracted with a private firm to provide some of these services through a sole-source contract. The University *Fiscal Policy* allows for a noncompetitive (sole-source negotiation) contract when "the required service is available from only one vendor or firm offering specialized services." Although the sole-source justification on file at the university did document the specialized, relevant abilities of the firm, it did not state or adequately document that it was the only firm that could provide these particular services.

The subcontract was approved by the Vice Chancellor for Research, a campus-level official. According to current university policy, campus officials can approve contracts for services performed for the university. It would, however, appear that a sole-source subcontract such as this would require a higher level of review within the university system. When a state department or agency requests a sole-source procurement, the letter of justification must be approved by the Department of Finance and Administration. The university's *Fiscal Policy* does not require a comparable level of approval.

University *Fiscal Policy* requires that contracts "be made on a competitive basis whenever possible." The failure to consider additional vendors when awarding contracts could result in the university's paying excess amounts for services and missing relevant alternatives.

Recommendation

The university's reasons for the sole-source procurement of services should always be clearly identified and well documented. The university should consider revising its contracting policies to require that a listing of sole-source contract approvals be periodically forwarded to the Vice President for Business and Finance for his review.

Management's Comment

The University concurs with this recommendation. We concur that the University's documented justification for some sole-source contracts did not adequately address why only one vendor could provide the services. The University's current policy requires departments to provide their contracting office with sufficient documentation to justify the sole-source negotiation of a contract. However, a University internal audit of the contract review process, published in August of 1998, identified that available written justification seemed to emphasize the contractor's qualifications rather than explain why sole-source negotiation was used. The internal audit recommended the University develop a form for departments to provide the appropriate information to justify a sole-source contract. The internal audit also recommended the form be approved by the appropriate contract office and, when necessary, the purchasing office before a sole-source contract is executed. This form is currently being developed. In addition, the University will consider having the Office of the Vice President for Business and Finance review the justification for sole-source contracts.

5. Purchasing department personnel failed to follow the university's purchasing procedures

Finding

Purchasing department personnel systemwide did not fully comply with the university's established purchasing procedures concerning informal competitive price quotations and sole-source purchases.

The *Fiscal Policy* of the University of Tennessee states that vendor selection for purchases between \$1,000 and \$5,000 "will be based on informal competitive price quotations from at least three sources" (Statement 5, Section 50, Part 3). Purchasing department personnel, however, did not obtain three price quotations for eight of fourteen disbursements in this group tested at the University of Tennessee at Memphis (57%). In each case, at least three vendors were contacted, but one of the vendors failed to bid. By obtaining three price quotations, the university should obtain the best possible price.

Discussions with purchasing department personnel at the Knoxville campus, the Chattanooga campus, Memorial Hospital in Knoxville, and the University of Tennessee Space

Institute revealed that personnel commonly consider contacting three vendors sufficient even though they may not receive price quotations from all three.

The *Fiscal Policy* of the University of Tennessee also states that “products or services the Purchasing Department determines to be sole-source or proprietary may be exempted from the competitive bid requirements with the approval of the campus/unit Chief Business or Administrative Officer (or designee)” (Statement 5, Section 50, Part 3). Two disbursements tested at UT Memphis were considered non-biddable, sole-source purchases, but there was not adequate, written justification for the purchases nor was there proper approval by the campus chief business officer or his designee.

In another instance, UT Memphis personnel did not properly bid a blanket purchase order for \$2,200 of two distinct types of oxygen supply tanks for the year ended December 31, 1997. Blanket purchase orders are subject to the competitive-bidding process whenever possible. In this case, three informal bids were required.

Recommendation

University management should take steps to ensure that personnel know and follow the *Fiscal Policy* pertaining to purchasing. Purchases the purchasing department determines are sole-source products or services should be adequately documented as such in writing and be approved by the appropriate university officials. University management should also take steps to ensure that all purchasing personnel understand the *Fiscal Policy* related to blanket purchase orders. In addition, the purchasing department should always obtain three price quotations during the informal bidding process.

Management’s Comment

The University concurs with the finding. The UT Systems Purchasing directors have made a request to the Office of Audit and Management Services to consider changing University policy relating to purchases over \$1,000 and under \$5,000 to read: “based on soliciting informal competitive quotations from at least three sources.”

The UT Memphis buying staff have been instructed to ensure that purchase order files have approvals and documentation supporting requests for non-biddable, sole-source purchases.

Independent Auditor's Report

September 25, 1998

The Honorable W. R. Snodgrass
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Snodgrass:

We have audited the accompanying balance sheet of the University of Tennessee, which is a component unit of the State of Tennessee, as of June 30, 1998, and the related statements of changes in fund balances and current funds revenues, expenditures, and other changes for the year then ended. These financial statements are the responsibility of the university's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Honorable W. R. Snodgrass
September 25, 1998
Page Two

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the University of Tennessee, as of June 30, 1998, and the changes in fund balances and the current funds revenues, expenditures, and other changes for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note 13 to the financial statements, the university implemented GASB 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, and GASB 16, *Accounting for Compensated Absences*, in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 25, 1998, on our consideration of the university's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

Sincerely,

Arthur A. Hayes, Jr., CPA, Director
Division of State Audit

AAH/sdr

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THE UNIVERSITY OF TENNESSEE
BALANCE SHEET
JUNE 30, 1998, WITH TOTALS AS OF JUNE 30, 1997

Exhibit A

ASSETS	Current Funds					Plant Funds		
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Life Income Funds	Unexpended	Retirement of Indebtedness and	
							Renewals and Replacements	
Cash and cash equivalents (Note 2)	\$ 138,749,810.00	\$ 22,063,309.95	\$ 5,235,496.62	\$ 19,145,081.37	\$ 445,920.47	\$ -	\$ 116,170,233.16	
Assets with University Health System, Inc. (Notes 2 and 15)	5,180,899.20	-	-	-	-	-	-	
Assets with trustees (Notes 2 and 9)	-	-	-	1,824,580.00	-	-	326,618.60	
Investments (Note 2)	-	625,025.71	-	312,657,504.42	43,740,573.38	122,700.00	-	
Accounts receivable (net of allowance of \$46,085,484.97 at June 30, 1998, and \$47,407,017.93 at June 30, 1997)	87,077,027.01	61,150,440.17	814,199.54	2,140,597.50	12,127.30	-	102,149.23	
Notes receivable (net of allowance of \$1,158,646.47 at June 30, 1998, and \$1,215,815.79 at June 30, 1997)	-	-	32,078,486.80	-	-	-	-	
State capital outlay and maintenance receivable	-	-	-	-	-	623,712.88	-	
Tennessee State School Bond Authority debt proceeds receivable (Note 1)	-	-	-	-	-	3,452,900.81	-	
Due from other funds	99,359.39	-	-	-	-	-	4,949,310.69	
Inventories (Note 1)	9,849,484.23	-	-	-	-	-	-	
Prepaid expenses and deferred charges	4,069,996.95	-	-	-	-	-	-	
Land	-	-	-	-	-	-	-	
Structures and improvements	-	-	-	-	-	-	-	
Machinery and equipment	-	-	-	-	-	-	-	
Library holdings	-	-	-	-	-	-	-	
Livestock	-	-	-	-	-	-	-	
Total assets	\$ 245,026,576.78	\$ 83,838,775.83	\$ 38,128,182.96	\$ 335,767,763.29	\$ 44,198,621.15	\$ 4,199,313.69	\$ 121,548,311.68	

LIABILITIES AND FUND BALANCES

Liabilities:							
Accounts payable (Note 1)	\$ 56,662,728.57	\$ 3,681,234.58	\$ -	\$ 562,667.10	\$ -	\$ 4,114,253.34	\$ -
Accrued liabilities	27,094,388.69	282,299.60	-	-	-	-	-
Tennessee State School Bond Authority indebtedness (Note 4)	-	-	-	-	-	3,452,900.81	-
Due to other funds	-	-	-	-	99,359.39	4,949,310.69	-
Notes payable (Note 4)	-	-	-	-	-	-	-
Accrued compensated absences (Note 1)	50,109,620.80	-	-	-	-	-	-
Lease obligations payable (Note 6)	-	-	-	-	-	-	-
Deferred revenue	22,425,275.12	-	-	-	-	-	-
Amounts held in custody for the university	-	-	-	-	-	-	-
Amounts held in custody for others	-	-	-	-	-	-	-
Deposits payable	2,617,478.18	-	-	-	-	-	-
Total liabilities	158,909,491.36	3,963,534.18	-	562,667.10	99,359.39	12,516,464.84	-
Fund balances:							
Allocation for working capital (Note 1)	92,665,824.99	-	-	-	-	-	-
Allocation for encumbrances (Note 10)	10,743,210.30	-	-	-	-	-	-
Allocation for compensated absences	(50,109,620.80)	-	-	-	-	-	-
Other allocations	13,284,484.69	-	-	-	-	-	-
Restricted	-	79,875,241.65	-	-	-	-	-
U.S. Government grants refundable	-	-	31,152,013.25	-	-	-	-
Institutional loan funds	-	-	6,976,169.71	-	-	-	-
Endowment	-	-	-	314,626,638.34	-	-	-
Quasi-endowment - unrestricted	-	-	-	20,562,113.11	-	-	-
Quasi-endowment - restricted	-	-	-	16,344.74	-	-	-
Life income	-	-	-	-	44,099,261.76	-	-
Plant - unrestricted	-	-	-	-	-	(12,079,833.50)	120,995,783.12
Plant - restricted	-	-	-	-	-	3,762,682.35	552,528.56
Net investment in plant	-	-	-	-	-	-	-
Unallocated	19,533,186.24	-	-	-	-	-	-
Total fund balances	86,117,085.42	79,875,241.65	38,128,182.96	335,205,096.19	44,099,261.76	(8,317,151.15)	121,548,311.68
Total liabilities and fund balances	\$ 245,026,576.78	\$ 83,838,775.83	\$ 38,128,182.96	\$ 335,767,763.29	\$ 44,198,621.15	\$ 4,199,313.69	\$ 121,548,311.68

Investment in Plant	Agency Funds	Totals (Memorandum Only)		University Health System December 31, 1997	Totals (Memorandum Only)	
		1998	1997		1998	1997
\$ -	\$ 4,363,954.71	\$ 306,173,806.28	\$ 294,768,449.26	\$ 4,519,390.00	\$ 310,693,196.28	\$ 307,637,683.26
-	-	5,180,899.20	2,316,038.33	-	5,180,899.20	2,316,038.33
-	-	2,151,198.60	1,901,149.79	-	2,151,198.60	1,901,149.79
-	4,252,750.85	361,398,554.36	291,403,387.61	1,137,730.00	362,536,284.36	293,096,202.61
-	426,684.93	151,723,225.68	141,836,574.92	1,757,634.00	153,480,859.68	142,622,151.92
-	-	32,078,486.80	30,120,533.68	-	32,078,486.80	30,120,533.68
-	-	623,712.88	411,411.26	-	623,712.88	411,411.26
-	-	3,452,900.81	3,500,505.79	-	3,452,900.81	3,500,505.79
-	-	5,048,670.08	2,751,813.46	-	5,048,670.08	2,751,813.46
-	-	9,849,484.23	10,636,638.69	-	9,849,484.23	10,636,638.69
-	-	4,069,996.95	3,895,140.67	88,250.00	4,158,246.95	3,964,832.67
34,652,903.21	-	34,652,903.21	34,481,903.21	-	34,652,903.21	34,481,903.21
1,121,244,050.57	-	1,121,244,050.57	1,080,205,533.65	155,033.00	1,121,399,083.57	1,080,405,858.65
425,728,740.64	-	425,728,740.64	404,706,660.34	306,608.00	426,035,348.64	405,034,530.34
245,629,966.00	-	245,629,966.00	240,314,350.00	-	245,629,966.00	240,314,350.00
1,877,042.00	-	1,877,042.00	1,813,080.00	-	1,877,042.00	1,813,080.00
\$ 1,829,132,702.42	\$ 9,043,390.49	\$ 2,710,883,638.29	\$ 2,545,063,170.66	\$ 7,964,645.00	\$ 2,718,848,283.29	\$ 2,561,008,683.66

The notes to the financial statements are an integral part of this statement

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CHANGES IN FUND BALANCES
FOR THE YEAR ENDED JUNE 30, 1998

	Current Funds					Plant Funds						
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Life Income Funds	Unexpended	Retirement of Indebtedness and Renewals and Replacements	Investment In Plant	Totals (Memorandum Only) 1998	University Health System December 31, 1997	Totals (Memorandum Only) 1998	
REVENUES AND OTHER ADDITIONS												
Unrestricted current funds revenues	\$ 1,006,839,580.42	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,006,839,580.42	\$ -	\$ 1,006,839,580.42	
Restricted gifts and grants	-	240,477,893.78	-	14,387,419.37	6,265,863.80	-	-	-	261,131,176.95	-	261,131,176.95	
Federal Perkins loan funds	-	-	461,910.19	-	-	-	-	-	461,910.19	-	461,910.19	
Federal nursing and health professions loan funds	-	-	52,894.17	-	-	-	-	-	52,894.17	-	52,894.17	
Interest on notes receivable	-	-	780,299.80	-	-	-	-	-	780,299.80	-	780,299.80	
Endowment income	-	8,436,012.44	74,388.99	391,727.43	-	-	-	-	8,902,128.86	-	8,902,128.86	
Investment income	-	91,947.31	192,426.19	38,644,845.89	5,029,805.51	43,648.74	5,658,599.61	-	49,661,273.25	-	49,661,273.25	
State appropriations for capital outlay	-	-	-	-	-	11,165,348.59	-	-	11,165,348.59	-	11,165,348.59	
Tennessee State School Bond Authority proceeds	-	-	-	-	-	16,013,557.57	-	-	16,013,557.57	-	16,013,557.57	
Capital lease acquisitions	-	-	-	-	-	-	-	608,783.79	608,783.79	-	608,783.79	
Gifts and other sources	-	-	14,208.64	-	-	3,209,540.11	6,701.47	2,193,120.52	5,423,570.74	-	5,423,570.74	
Student debt service fees	-	-	-	-	-	-	2,787,081.75	-	2,787,081.75	-	2,787,081.75	
Federal interest subsidy grants	-	-	-	-	-	-	127,553.00	-	127,553.00	-	127,553.00	
Special state legislature appropriations	-	-	-	-	-	-	201,275.57	-	201,275.57	-	201,275.57	
Expended for plant facilities (including \$48,036,099.78 charged to current fund expenditures)	-	-	-	-	-	-	-	90,946,968.86	90,946,968.86	-	90,946,968.86	
Retirement of indebtedness	-	-	-	-	-	-	-	52,095,827.13	52,095,827.13	-	52,095,827.13	
Component unit revenue	-	-	-	-	-	-	-	-	-	6,236,193.00	6,236,193.00	
Total revenues and other additions	1,006,839,580.42	249,005,853.53	1,576,127.98	53,423,992.69	11,295,669.31	30,432,095.01	8,781,211.40	145,844,700.30	1,507,199,230.64	6,236,193.00	1,513,435,423.64	
EXPENDITURES AND OTHER DEDUCTIONS												
Unrestricted current fund expenditures	941,633,366.39	-	-	-	-	-	-	-	941,633,366.39	-	941,633,366.39	
Restricted current fund expenditures	-	225,176,401.13	-	-	-	-	-	-	225,176,401.13	-	225,176,401.13	
Administration and collection costs	-	-	98,243.15	-	-	-	-	-	98,243.15	-	98,243.15	
Loan cancellations and write-offs	-	-	257,529.97	-	-	-	-	-	257,529.97	-	257,529.97	
Payments to beneficiaries	-	-	-	-	2,690,774.31	-	-	-	2,690,774.31	-	2,690,774.31	
Expended for plant facilities	-	-	-	-	-	42,595,913.73	314,955.35	-	42,910,869.08	-	42,910,869.08	
Retirement of indebtedness	-	-	-	-	-	-	18,938,989.37	-	18,938,989.37	-	18,938,989.37	
Interest on indebtedness	-	-	-	-	-	-	14,473,939.57	-	14,473,939.57	-	14,473,939.57	
Disposal of plant facilities	-	-	-	-	-	-	-	19,000.00	19,000.00	-	19,000.00	
Buildings and improvements written off and adjustments	-	-	-	-	-	-	-	59,132.32	59,132.32	-	59,132.32	
Physical inventory adjustments	-	-	-	-	-	-	-	25,363,922.29	25,363,922.29	-	25,363,922.29	
Increase in indebtedness	-	-	-	-	-	-	-	49,157,199.16	49,157,199.16	-	49,157,199.16	
Indirect costs recovered	-	19,270,516.13	-	-	-	-	-	-	19,270,516.13	-	19,270,516.13	
Component unit expenses	-	-	-	-	-	-	-	-	-	5,393,185.00	5,393,185.00	
Other	-	695,735.71	4,211.03	1,537.67	1,006.53	7,616,118.27	-	-	8,318,609.21	-	8,318,609.21	
Total expenditures and other deductions	941,633,366.39	245,142,652.97	359,984.15	1,537.67	2,691,780.84	50,212,032.00	33,727,884.29	74,599,253.77	1,348,368,492.08	5,393,185.00	1,353,761,677.08	

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CHANGES IN FUND BALANCES
FOR THE YEAR ENDED JUNE 30, 1998

	Current Funds					Plant Funds			Totals (Memorandum Only) 1998	University Health System December 31, 1997	Totals (Memorandum Only) 1998
	Unrestricted	Restricted	Loan Funds	Endowment and Similar Funds	Life Income Funds	Unexpended	Retirement of Indebtedness and Renewals and Replacements	Investment In Plant			
TRANSFERS AMONG FUNDS - ADDITIONS (DEDUCTIONS)											
Mandatory:											
Principal and interest	(26,333,169.39)	-	-	-	-	-	26,333,169.39	-	-	-	-
Loan funds matching	(161,866.28)	30,127.89	131,738.39	-	-	-	-	-	-	-	-
Endowment and similar funds	-	-	-	2,820,667.99	(2,820,667.99)	-	-	-	-	-	-
Nonmandatory:											
Restricted current funds	3,222.56	(3,107,484.78)	-	(2,053,816.75)	-	5,158,054.27	24.70	-	-	-	-
Endowment and similar funds	(47,000.00)	20,920.28	-	225,302.98	(20,920.28)	(178,302.98)	-	-	-	-	-
Unexpended plant	(4,349,421.78)	-	-	-	-	12,689,125.26	(8,339,703.48)	-	-	-	-
Retirement of indebtedness	(28,754,651.22)	-	-	(484,736.73)	-	-	29,239,387.95	-	-	-	-
Total transfers	(59,642,886.11)	(3,056,436.61)	131,738.39	507,417.49	(2,841,588.27)	17,668,876.55	47,232,878.56	-	-	-	-
Net increase (decrease) for the year	5,563,327.92	806,763.95	1,347,882.22	53,929,872.51	5,762,300.20	(2,111,060.44)	22,286,205.67	71,245,446.53	158,830,738.56	843,008.00	159,673,746.56
Fund balance at July 1, 1997, restated	80,553,757.50	79,068,477.70	36,780,300.74	281,275,223.68	38,336,961.56	(6,206,090.71)	99,262,106.01	1,497,165,882.69	2,106,236,619.17	1,991,110.00	2,108,227,729.17
Fund balance at June 30, 1998	<u>\$ 86,117,085.42</u>	<u>\$ 79,875,241.65</u>	<u>\$ 38,128,182.96</u>	<u>\$ 335,205,096.19</u>	<u>\$ 44,099,261.76</u>	<u>\$ (8,317,151.15)</u>	<u>\$ 121,548,311.68</u>	<u>\$ 1,568,411,329.22</u>	<u>\$ 2,265,067,357.73</u>	<u>\$ 2,834,118.00</u>	<u>\$ 2,267,901,475.73</u>

The notes to the financial statements are an integral part of this statement.

THE UNIVERSITY OF TENNESSEE
STATEMENT OF CURRENT FUNDS REVENUES, EXPENDITURES, AND OTHER CHANGES
FOR THE YEAR ENDED JUNE 30, 1998
WITH COMPARATIVE TOTALS FOR THE YEAR ENDED JUNE 30, 1997

	Current Year			Prior Year
	Unrestricted	Restricted	Total	Total
REVENUES				
Tuition and fees	\$ 145,769,441.48	\$ -	\$ 145,769,441.48	\$ 131,195,419.92
Federal appropriations	13,091,032.76	-	13,091,032.76	13,397,290.02
State appropriations	352,112,550.00	10,872,283.03	362,984,833.03	367,737,839.06
Local appropriations	2,734,554.05	-	2,734,554.05	2,179,554.33
Federal grants and contracts	14,683,160.48	81,431,985.62	96,115,146.10	97,635,934.07
State grants and contracts	2,051,704.56	35,732,901.43	37,784,605.99	28,337,872.58
Local grants and contracts	2,916,653.39	5,839,010.50	8,755,663.89	9,090,220.29
Private gifts, grants, and contracts	4,310,225.62	74,442,455.13	78,752,680.75	79,244,774.82
Endowment income - university and other	63,109.78	13,621,884.77	13,684,994.55	13,876,620.17
Sales and services of educational activities	32,901,168.71	-	32,901,168.71	33,956,141.91
Investment income	13,930,965.49	-	13,930,965.49	12,355,718.05
Other sources	8,321,278.33	-	8,321,278.33	7,954,667.40
Total educational and general	592,885,844.65	221,940,520.48	814,826,365.13	796,962,052.62
Sales and services of auxiliary enterprises	107,345,267.99	233,528.01	107,578,796.00	115,106,181.80
Sales and services of hospitals	306,608,467.78	3,002,352.64	309,610,820.42	311,471,124.47
Total current revenues	1,006,839,580.42	225,176,401.13	1,232,015,981.55	1,223,539,358.89
EXPENDITURES AND TRANSFERS				
Educational and general expenditures:				
Instruction	261,608,445.12	46,460,757.07	308,069,202.19	307,845,690.11
Research	36,762,890.03	89,033,946.58	125,796,836.61	129,014,872.50
Public service	45,053,455.65	47,237,866.19	92,291,321.84	90,486,694.38
Academic support	66,990,757.65	6,192,689.97	73,183,447.62	72,238,533.01
Student services	39,253,152.26	1,827,045.37	41,080,197.63	37,456,160.66
Institutional support	54,498,555.60	2,860,968.29	57,359,523.89	56,432,836.08
Operation and maintenance of plant	48,528,060.79	132,057.51	48,660,118.30	47,062,278.16
Scholarships and fellowships	19,305,078.68	28,195,189.50	47,500,268.18	42,642,502.10
Total educational and general expenditures	572,000,395.78	221,940,520.48	793,940,916.26	783,179,567.00
Mandatory transfers for:				
Principal and interest	4,271,470.42	-	4,271,470.42	3,626,494.47
Loan funds	161,866.28	-	161,866.28	69,523.71
Nonmandatory transfers for:				
Retirement of indebtedness	15,142,150.92	-	15,142,150.92	13,239,897.67
Endowment and similar funds	12,000.00	-	12,000.00	7,000.00
Restricted current funds	(20,882.56)	-	(20,882.56)	823,391.89
Unexpended plant	970,596.23	-	970,596.23	1,517,357.83
Auxiliary enterprises	(4,307,013.52)	-	(4,307,013.52)	(4,252,251.14)
Hospitals	(1,984,018.48)	-	(1,984,018.48)	(1,795,988.84)
Total educational and general expenditures and transfers	586,246,565.07	221,940,520.48	808,187,085.55	796,414,992.59
Auxiliary enterprises:				
Expenditures	84,597,058.38	233,528.01	84,830,586.39	96,904,235.67
Mandatory transfer for:				
Principal and interest	11,605,616.44	-	11,605,616.44	11,024,776.79
Nonmandatory transfers for:				
Retirement of indebtedness	5,612,500.30	-	5,612,500.30	2,906,242.68
Unexpended plant	1,285,684.09	-	1,285,684.09	1,003,049.31
Restricted current funds	17,660.00	-	17,660.00	20,000.00
Educational and general	4,307,013.52	-	4,307,013.52	4,252,251.14
Total auxiliary enterprises expenditures and transfers	107,425,532.73	233,528.01	107,659,060.74	116,110,555.59
Hospitals:				
Expenditures	285,035,912.23	3,002,352.64	288,038,264.87	299,917,108.76
Mandatory transfer for:				
Principal and interest	10,456,082.53	-	10,456,082.53	10,337,134.86
Nonmandatory transfers for:				
Educational and general	1,984,018.48	-	1,984,018.48	1,795,988.84
Endowment and similar funds	35,000.00	-	35,000.00	44,999.50
Retirement of indebtedness	8,000,000.00	-	8,000,000.00	-
Unexpended plant	2,093,141.46	-	2,093,141.46	3,229,205.00
Total hospitals expenditures and transfers	307,604,154.70	3,002,352.64	310,606,507.34	315,324,436.96
Total expenditures and transfers	1,001,276,252.50	225,176,401.13	1,226,452,653.63	1,227,849,985.14
Excess (deficiency) revenues over (under) expenditures and transfers:				
Educational and general	6,639,279.58	-	6,639,279.58	547,060.03
Auxiliary enterprises	(80,264.74)	-	(80,264.74)	(1,004,373.79)
Hospitals	(995,686.92)	-	(995,686.92)	(3,853,312.49)
OTHER TRANSFERS AND ADDITIONS (DEDUCTIONS)				
Restricted receipts in excess of expenditures	-	23,829,452.40	23,829,452.40	30,660,528.45
Indirect costs recovered	-	(19,270,516.13)	(19,270,516.13)	(19,399,567.32)
Restricted gifts transferred to other funds	-	(3,752,172.32)	(3,752,172.32)	(578,518.56)
Net increase in fund balances	\$ 5,563,327.92	\$ 806,763.95	\$ 6,370,091.87	\$ 6,371,816.32

The notes to the financial statements are an integral part of this statement.

The University of Tennessee
Notes to the Financial Statements
June 30, 1998, and June 30, 1997

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The university is a component unit of the State of Tennessee and is discretely presented in the *Tennessee Comprehensive Annual Financial Report*. Although the university is a separate legal entity, the state is financially accountable for the university because the state appoints a majority of its governing body and is obligated to provide financial support.

The University of Tennessee System is composed of the University of Tennessee, Knoxville; the University of Tennessee at Chattanooga; the University of Tennessee at Martin; the University of Tennessee - Center for the Health Sciences, composed of the Memphis campus, the Memorial Research Center at Knoxville, Clinical Education Centers at Chattanooga and Knoxville, Family Practice Centers at Jackson, Knoxville, and Memphis, and hospitals in Knoxville and Memphis; the University of Tennessee Space Institute at Tullahoma; the University of Tennessee Institute of Agriculture, composed of the College of Agriculture at Knoxville, the Agricultural Experiment Stations, the Agricultural Extension Service, and the College of Veterinary Medicine at Knoxville; the Institute for Public Service, which includes the County Technical Assistance Service and the Municipal Technical Advisory Service; and the University-Wide Administration. The university is governed by a board of 19 members, including one student member, all appointed by the Governor, who also serves as Chairman. The President is the Chief Executive Officer of the university system.

As required by generally accepted accounting principles, these financial statements present the financial position and financial activities of the university and its component unit as well as certain activities and expenditures funded by other state agencies on behalf of the university or its employees. The component unit discussed below is included in the university's financial reporting entity because the university has appointment authority of its board. The component unit is presented discretely in a separate column in the combined financial statements to emphasize it is legally separate from the university.

Discretely Presented Component Unit

University Health System, Inc. (UHS) was formed to provide practice management and other administrative services to physician groups, physicians associations, and the

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

University of Tennessee Medical Center at Knoxville. Because the university controls the majority of the governing board, UHS must be presented as a component unit in accordance with GASB Statement 14, *The Financial Reporting Entity*. The transactions between the university and UHS will not agree in the accompanying financial statements because they have different fiscal year-ends. All activity reported for UHS, including the information shown in the Notes to the Financial Statements, is as of and for the year ended December 31, 1997. Complete financial statements of UHS can be obtained at University Health System, Inc.; 9000-C Executive Park Drive; Knoxville, Tennessee 37923

Basis of Presentation

The financial statements for the University of Tennessee are prepared in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. The university uses the AICPA College Guide model for accounting and financial reporting.

Basis of Accounting

The financial statements of the University of Tennessee have been prepared on the accrual basis except that depreciation on plant assets is not recorded and revenues and expenditures of an academic term encompassing more than one fiscal year are reported solely in the fiscal year in which the term is predominately conducted. All unrestricted resources are reported as revenue in the year they are earned. All restricted resources are recorded as additions to the fund balances of the appropriate fund groups. Restricted current resources are then recorded as revenues during the period in which they are expended. The statement of current funds revenues, expenditures, and other changes is a statement of financial activities of current funds related to the current reporting period. It does not purport to present the results of operations or the net income or loss for the period, as would a statement of income or a statement of revenues and expenses.

To the extent that current funds are used to finance plant assets, the funds are accounted for as (1) expenditures, for normal replacement of movable equipment and library holdings; (2) mandatory transfers, for required debt amortization and interest and equipment renewal and replacement; and (3) nonmandatory transfers, for all other cases.

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Notes to the Financial Statements (Cont.)
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Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available, the university maintains accounts in accordance with the principles of fund accounting. With this procedure, resources for various purposes are classified for accounting and reporting purposes into funds for specified activities or objectives. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds with similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

Within each fund group, fund balances restricted by outside sources are so indicated and are distinguished from unrestricted funds which are allocated to specific purposes by the governing board. Externally restricted funds may be used only in accordance with the purposes established by the source of such funds and contrast with unrestricted funds over which the governing board retains full control to use in achieving any of its institutional purposes. Other allocations of fund balances include unemployment compensation, revolving accounts, unexpended gifts, and reappropriations. They were made in accordance with university policies.

All gains and losses arising from the sale, collection, or other disposition of investments and other non-cash assets are accounted for in the fund that owned such assets. Ordinary income derived from investments, receivables, and the like is accounted for in the fund owning such assets, except for income derived from investments of endowment and similar funds. This income is accounted for in the fund to which it is restricted or, if unrestricted, as revenues in unrestricted current funds.

All other unrestricted revenue is accounted for in the unrestricted current funds. Restricted gifts, grants, appropriations, endowment income, and other restricted resources are accounted for in the appropriate restricted funds. Restricted current funds are reported as revenues and expenditures when expended for current operating purposes.

Current Funds

Unrestricted current funds consist of those funds over which the university retains full control for use in achieving any of its authorized institutional purposes. Auxiliary enterprises activities are included in unrestricted current funds and include student housing, bookstores, food services, parking services, and certain other activities. Hospital activities are also included in unrestricted current funds. Restricted current

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funds are externally restricted and may be used only in accordance with the purposes established by their source.

Loan Funds

Loan funds consist of resources made available for student loans.

Endowment and Similar Funds

Endowment funds are subject to the restrictions of gift instruments requiring in perpetuity that the principal be invested and only the income be used. Although quasi-endowment funds have been established by the governing board for the same purpose as endowment funds, any portion of quasi-endowment funds may be expended. Since these funds are internally designated, the governing board retains the right to alter or amend such designation.

Life Income Funds

Life income funds are funds held in trust by the university under agreement with donors whereby designated beneficiaries receive specified interests in annual income of the trust. Upon death of the beneficiaries or other termination of the trust, such trust assets become available to the university for use as set forth in each agreement.

Plant Funds

The plant funds group consists of (1) unexpended plant funds which are to be used for the construction or acquisition of physical properties for institutional purposes; (2) retirement of indebtedness and renewal and replacement funds, which are funds set aside for debt service charges and for the retirement of indebtedness on institutional properties, and major maintenance items on institutional properties, respectively; and (3) investment in plant funds which are funds expended for, and thus invested in, institutional properties.

Agency Funds

The university acts solely as an agent in the handling of these funds; consequently, transactions of these funds do not affect the university's operating statements.

Inventories

Inventories are valued at cost, which is lower than market, based on the retail, specific identification, average cost, or first-in, first-out basis.

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Investments

Investments in commercial paper are reported at amortized cost at June 30, 1998, and at fair value at June 30, 1997. All other investments are reported at fair value.

Investment in Plant

Physical plant, equipment, and land are stated at cost at date of purchase or at fair value at date of donation. Depreciation on the physical plant and equipment is not recorded. Purchases of library books and holdings are recorded as current fund expenditures and capitalized at standardized costs in the plant funds. Library books are valued at \$48 per volume and other library holdings are valued at various standardized values which approximate current costs. Livestock is valued at estimated market value. Equipment expenditures are capitalized when the unit acquisition cost is \$1,000 or greater and the estimated useful life is two years or more.

Capitalized Interest

The university capitalizes interest cost in excess of earnings on debt associated with capital projects as a component of buildings. Therefore, asset values in the investment in plant subgroup include such interest costs.

Accounts Payable

Included in unrestricted current funds—accounts payable are checks payable in the amount of \$9,805,236.49 and \$5,318,015.84 as of June 30, 1998, and June 30, 1997, respectively. These amounts represent the sum of checks written in excess of the university's checking account balance because of the use of a controlled disbursement account. In this way, the university maximizes interest income by transferring from an investment account only funds necessary to cover the checks that clear the bank daily.

Accrued Compensated Absences

The university's employees accrue annual leave at varying rates, depending on length of service or classification. Some employees also earn compensatory time. Generally, all permanent full-time employees and certain part-time employees are entitled to accrue and carry forward calendar-year maximums of 42 days annual vacation leave, except nine-month faculty members who do not accrue annual leave. The amount reflects, as of June 30, all unused vacation leave payable upon termination. The liability is inventoried at fiscal year-end using current salary costs and the cost of the salary-related benefit payments and is recorded in current funds. The net change in the liability is recorded in the current year in the applicable current funds functional expenditure categories. Since the liability is expected to be funded primarily from

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future unrestricted and restricted revenue sources, a related allocation has been made to the current fund balance so that these fund balances reflect current available funds.

Allocation for Working Capital

The unrestricted fund balance is allocated for the amount of working capital. "Working capital" is defined as the total of all petty cash, accounts receivable, and inventories in the unrestricted current fund at the balance sheet date except for student receivables credited to deferred revenue, accrued interest, and amounts due on federal letters of credit, less the accrued benefits on accrued faculty salaries.

Income Taxes

The university, as a public corporation and an instrumentality of the State of Tennessee, is exempt from federal income taxes under Section 115 of the *Internal Revenue Code*. Contributions to the university are deductible by donors as provided under Section 170 of the *Internal Revenue Code*.

Tennessee State School Bond Authority Debt Proceeds Receivable

Tennessee State School Bond Authority Debt Proceeds Receivable in unexpended plant consist of Tennessee State School Bond Authority debt issued for which the proceeds have not yet been received.

Totals (Memorandum Only)

Total columns on the general-purpose financial statements are captioned "memorandum only" to indicate that they are presented only to facilitate financial analysis. Data in these columns do not present financial position or results of operations in conformity with generally accepted accounting principles. Neither are such data comparable to a consolidation. Interfund eliminations have not been made in the aggregation of this data.

NOTE 2. DEPOSITS AND INVESTMENTS

Investment Policy

The University of Tennessee maintains in unrestricted current funds a cash management investment pool that is available for use by all fund groups. State statutes and university investment policies authorize the university's cash management pool to invest in collateralized Tennessee bank or savings and loan association certificates of deposit, U. S. Treasury obligations, U. S. government agency obligations, repurchase

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agreements of those securities, highest quality commercial paper, prime bankers' acceptances, and money market mutual funds meeting certain criteria.

In accordance with state statutes, commercial banks and savings and loan associations that do not participate in the State of Tennessee Collateral Pool for Public Deposits must pledge securities with third parties as collateral to secure university time and demand deposits. Market values of these securities are regularly monitored to ascertain that 105% of university deposits, less the amounts protected by the Federal Deposit Insurance Corporation, are secured.

Two categories of university funds are subject to long-term investment, the endowment and similar funds and the life income funds. The investment of these funds is governed by the gift instrument and the investment policies established by the Board of Trustees. For a more complete description of these investments, please refer to Note 3, "Endowment and Similar Funds and Life Income Funds."

Cash and Cash Equivalents

In addition to petty cash and demand deposits, this classification includes instruments which are readily convertible to known amounts of cash. At June 30, 1998, cash and cash equivalents consisted of \$6,759,395.05 in bank accounts, \$1,812,888.00 of petty cash on hand, \$3,090,000.00 of certificates of deposit, and \$281,713,060.91 in the university's cash management investment pool. At June 30, 1997, cash and cash equivalents consisted of \$9,905,936.96 in bank accounts, \$1,458,565.01 of petty cash on hand, \$2,970,000.00 of certificates of deposit, and \$266,175,821.00 in the university's cash management investment pool. Additionally, the university maintains custodial accounts at First Tennessee Bank for funds contractually managed by independent investment counsel. In accordance with the custody agreement, First Tennessee Bank placed cash equivalents of \$12,798,462.32 at June 30, 1998, and \$14,258,126.29 at June 30, 1997, in the bank's money market mutual fund.

Deposits

Deposits with financial institutions are required to be categorized to indicate the level of custodial risk assumed by the university. Category 1 consists of deposits that are insured or collateralized with securities held by the university or by its agent in the university's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the university's name. Category 3 deposits are uncollateralized. This category includes any bank balance that is collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the university's name.

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Some of the university's bank accounts are in financial institutions which participate in the bank collateral pool administered by the Treasurer of the State of Tennessee. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

At June 30, 1998, the carrying amount of the university's deposits was \$9,849,395.05, and the bank balance including accrued interest was \$13,788,579.28. The entire bank balance was category 1.

At June 30, 1997, the carrying amount of the university's deposits was \$12,875,936.96, and the bank balance including accrued interest was \$19,991,154.48. The entire bank balance was category 1.

The laws of the State of Tennessee require that collateral be pledged to secure all uninsured deposits.

Cash Management Investment Pool

The cash management investment pool consists of marketable securities and government repurchase agreements as previously described. The reported amount of the cash management pool at June 30, 1998, and June 30, 1997, was \$281,713,060.91 and \$266,175,821.00, respectively. The cost of the cash management pool at June 30, 1998, and June 30, 1997, was \$281,070,878.27 and \$265,346,277.62, respectively. The securities in the pool are categorized on the following page, listed as cash equivalents, to indicate the level of risk assumed by the university. The university's standard "Master Repurchase Agreements" require that the securities underlying repurchase agreements have fair value equal to or exceeding 100% of the cost of the repurchase agreement and be delivered to its agent's trust account at the Federal Reserve Bank-Memphis. The fair value of securities underlying repurchase agreements at June 30, 1998, was \$10,057,929.00. There were no government repurchase agreements for the university's cash management pool at June 30, 1997.

Investments

The university's investments are categorized below to indicate the level of custodial risk assumed by the university at year-end. Category 1 consists of insured or registered investments or investments for which the securities are held by the university or its agent in the university's name. Category 2 consists of uninsured or

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unregistered investments for which the securities are held by the counterparty's trust department or agent in the university's name. Category 3 consists of uninsured and unregistered investments for which the securities are held by the counterparty or by its trust department or agent but not in the university's name.

June 30, 1998

	Category			Reported	
	1	2	3	Amount	Cost
Cash equivalents					
Government securities	\$ 185,396,984.79	\$ -	\$ -	\$ 185,396,984.79	\$ 185,283,447.15
Repurchase agreements	9,000,000.00	800,000.00	-	9,800,000.00	9,800,000.00
Commercial paper	<u>86,516,076.12</u>	<u>-</u>	<u>-</u>	<u>86,516,076.12</u>	<u>85,987,431.12</u>
	<u>\$ 280,913,060.91</u>	<u>\$ 800,000.00</u>	<u>\$ -</u>	<u>\$ 281,713,060.91</u>	<u>\$ 281,070,878.27</u>
Investments					
Domestic securities					
Government securities	\$ 18,917,312.99	\$ 36,069,429.37	\$ -	\$ 54,986,742.36	\$ 52,888,442.73
Corporate bonds	3,727,587.39	34,655,910.20	-	38,383,497.59	37,629,804.02
Corporate stocks	104,793,984.22	5,950,524.10	-	110,744,508.32	91,704,921.95
Mortgages and notes	2,608,725.27	-	405,900.00	3,014,625.27	2,893,185.98
Other investments	29,055.00	-	-	29,055.00	29,055.00
International securities					
Corporate stocks	<u>2,762,037.50</u>	<u>-</u>	<u>-</u>	<u>2,762,037.50</u>	<u>2,530,710.39</u>
	<u>\$ 132,838,702.37</u>	<u>\$ 76,675,863.67</u>	<u>\$ 405,900.00</u>	<u>\$ 209,920,466.04</u>	<u>\$ 187,676,120.07</u>
	<u>\$ 413,751,763.28</u>	<u>\$ 77,475,863.67</u>	<u>\$ 405,900.00</u>		

University cash equivalents and investments not susceptible to categorization:

Cash equivalents - assets with First Tennessee Bank as custodian	\$ 12,798,462.32	\$ 12,798,462.32
Limited partnership-venture capital funds	12,107,337.08	11,341,633.23
Mutual funds	90,820,274.04	82,756,942.69
Real estate equity funds	17,787,635.28	18,870,039.81
Real estate gifts	6,783,909.59	6,937,362.15
International equity fund	23,056,819.73	13,000,000.00
Assets with University Health System	5,180,899.20	5,180,899.20
Assets with the University of Chattanooga Foundation	1,824,580.00	1,824,580.00
Assets with First American Bank	169,392.37	143,538.24
Assets with American National Bank	493,731.90	233,229.44
Assets with National Geographic Society	258,988.34	258,988.34
Total investments and cash equivalents	<u>\$ 662,915,556.8</u>	<u>\$ 622,092,673.76</u>
Less: Cash equivalents	<u>294,511,523.23</u>	
Total investments on the balance sheet	<u>\$ 368,404,033.57</u>	

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Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

June 30, 1997

	Category			Reported Amount	Cost
	1	2	3		
Cash equivalents					
Government securities	\$ 209,261,286.00	\$ -	\$ -	\$ 209,261,286.00	\$ 208,671,879.86
Commercial paper	<u>56,914,535.00</u>	<u>-</u>	<u>-</u>	<u>56,914,535.00</u>	<u>56,674,397.76</u>
	<u>\$ 266,175,821.00</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 266,175,821.00</u>	<u>\$ 265,346,277.62</u>
Investments					
Domestic securities					
Government securities	\$ 54,794,922.52	\$ -	\$ -	\$ 54,794,922.52	\$ 54,423,932.94
Corporate bonds	39,165,535.88	-	-	39,165,535.88	38,932,904.71
Corporate stocks	122,010,079.76	-	-	122,010,079.76	76,050,894.28
Mortgages and notes	2,959,853.56	-	5,802.95	2,965,656.51	2,932,321.20
Other investments	29,057.00	-	-	29,057.00	29,057.00
International securities					
Government bonds	14,600.00	-	-	14,600.00	15,000.00
Corporate bonds	600,116.00	-	-	600,116.00	604,026.57
Corporate stocks	<u>4,166,555.80</u>	<u>-</u>	<u>-</u>	<u>4,166,555.80</u>	<u>3,282,391.53</u>
	<u>\$ 223,740,720.52</u>	<u>\$ -</u>	<u>\$ 5,802.95</u>	<u>\$ 223,746,523.47</u>	<u>\$ 176,270,528.23</u>
	<u>\$ 489,916,541.52</u>	<u>\$ -</u>	<u>\$ 5,802.95</u>		
University cash equivalents and investments not susceptible to categorization:					
Cash equivalents - assets with First Tennessee Bank as custodian				\$ 14,258,126.29	\$ 14,258,126.29
Limited partnership-venture capital funds				9,933,414.89	10,523,596.21
Mutual funds				6,452,141.87	5,603,099.11
Real estate equity funds				17,030,803.09	16,369,207.80
Real estate gifts				7,220,948.72	7,362,101.28
International equity fund				21,279,897.20	13,000,000.00
Assets with University Health System				2,316,038.33	2,316,038.33
Assets with the University of Chattanooga Foundation				1,716,121.00	1,716,121.00
Assets with First American Bank				140,594.88	119,742.38
Assets with American National Bank				394,848.99	206,736.02
Domestic bond fund				<u>5,204,214.50</u>	<u>5,000,000.00</u>
Total investments and cash equivalents				<u>\$ 575,869,494.23</u>	<u>\$ 518,091,574.27</u>
Less: Cash equivalents				<u>280,433,947.29</u>	
Total investments on the balance sheet				<u>\$ 295,435,546.94</u>	

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Commercial paper is reported at amortized cost at June 30, 1998, and at fair value at June 30, 1997. The fair value of the commercial paper at June 30, 1998, was \$86,499,206.96.

Assets with trustees of \$125,192.63 and \$185,028.79 at June 30, 1998, and June 30, 1997, respectively, in retirement of indebtedness consisted of securities held in debt service reserve with First Tennessee Bank. Assets of \$201,425.97 with the Tennessee State School Bond Authority at June 30, 1998, in retirement of indebtedness consisted of securities in an interest rate reserve fund.

NOTE 3. ENDOWMENT AND SIMILAR FUNDS AND LIFE INCOME FUNDS

Two categories of university funds are subject to long-term investment, the endowment and similar funds and the life income funds. The investment of these funds is governed by the gift instrument and the investment policies established by the Board of Trustees.

Effective July 1, 1954, the university adopted the policy of investing endowment and similar funds over which it had full investment discretion (and on which the donor or governing gift instrument does not require separate investment) in the Consolidated Investment Pool. This pooling of investments affords closer supervision of the investment portfolio and provides, regardless of size, the advantages of participation in a well-diversified portfolio. All contributing endowments participate in the income and capital appreciation of the Pool on a per-share basis commensurate with its contribution to the Pool. New endowment funds purchase shares in the Pool at the end of each month at the then current market price per share determined by valuing the Pool at month-end market value and dividing by the number of pool units outstanding. Net realized capital gains are reinvested and may be used for any shortfall between current income and spending plan distributions. The spending plan provides distributions equal to 5% of a three-year moving average Pool market value determined as of December 31. The per-unit market value for participating endowments was \$3.464218 and \$3.065918 at June 30, 1998, and June 30, 1997, respectively. Income distributed was \$.11905 per share in 1998 and \$.108106 per share in 1997 or \$10,659,268.63 and \$9,178,103.81, respectively. All endowment and similar funds not invested as part of the Consolidated Investment Pool are separately invested to observe requirements or limitations imposed by donors. Income earned and distributed on separately invested endowment and similar funds amounted to \$495,419.38 for 1998 and \$418,624.58 for 1997.

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Notes to the Financial Statements (Cont.)
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Life income funds are separately invested entities requiring detailed accounting to reflect specific compliance with terms of each trust and applicable federal regulations. The investment objectives as reflected in each agreement vary widely since they are affected by the age, income level, and needs of the beneficiaries as well as motives and objectives of the donors. Interest, dividend, rent, and royalty income realized on these funds for 1998 amounted to \$2,389,334.06 and for 1997 amounted to \$2,091,090.99.

The fair value of endowment and similar funds at June 30, 1998, was \$335,767,763.29 and the cost was \$299,432,684.46. This compares with a June 30, 1997, fair value of \$282,233,333.00 and cost of \$227,444,081.80. The fair value of life income funds at June 30, 1998, was \$44,198,621.15, and cost was \$41,586,027.21. This compares with a June 30, 1997, fair value of \$38,410,528.21 and cost of \$36,991,645.53.

NOTE 4. TSSBA INDEBTNESS AND NOTES PAYABLE

Tennessee State School Bond Authority (TSSBA) bonds, with interest rates ranging from 3 % to 7 %, are due serially to 2026 and are secured by pledges of the facilities' revenue to which they relate and certain other revenues and fees of the university, including state appropriations. The total outstanding bonded indebtedness for the university was \$256,244,484.09 at June 30, 1998, and \$270,730,258.25 at June 30, 1997. The total bonded indebtedness reported on the balance sheet at June 30, 1998, is shown net of unaccreted bonds payable of \$9,823,755.90 and assets of \$29,250,209.00 held by the Tennessee State School Bond Authority. The total bonded indebtedness reported on the balance sheet at June 30, 1997, is shown net of unaccreted bonds payable of \$11,270,341.35 and assets of \$29,529,541.03 held by the Tennessee State School Bond Authority.

Included in the total outstanding indebtedness is a \$242,000 note with the Department of Education which was issued in March 1989. The note carries an interest rate of 3% and is due semiannually to 2003. The outstanding notes payable at June 30, 1998, and June 30, 1997, were \$89,024.97 and \$107,239.89, respectively.

The university's debt service requirements to maturity for all bonds and the Department of Education note payable at June 30 are as follows:

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1999	\$ 15,129,416.97
2000	14,668,899.20
2001	13,916,456.02
2002	14,545,838.70
2003	14,809,155.27
Subsequent Years	<u>183,263,742.90</u>
	<u>\$256,333,509.06</u>

Bond Anticipation Notes Program

Interim and short-term financing for various capital projects was secured through the Tennessee State School Bond Authority from the Bond Anticipation Notes (BANs) Program through November 30, 1997. Under the BANs Program, the final maturity of the notes was March 1, 1998; however, the notes were retired December 1, 1997, and redeemed with proceeds of the Commercial Paper Program. The notes bore interest at a variable rate which was paid monthly. The outstanding balance of the five-year notes was \$32,056,838.00 when retired on December 1, 1997, and \$33,216,838.05 was outstanding at June 30, 1997.

Commercial Paper Program

The Tennessee State School Bond Authority authorized the issuance of commercial paper on November 18, 1997, to finance costs of various capital projects. The commercial paper also refinanced certain outstanding bond anticipation note indebtedness that the authority had previously issued to finance costs of various capital projects. At June 30, 1998, \$43,008,676.70 had been issued for projects at the University of Tennessee.

The University of Tennessee contributes funds to the Interest Rate Reserve Fund equal to \$4.46 per thousand drawn in the tax-exempt program and \$6.16 per thousand drawn in the taxable program. A contribution is required each time an additional draw is made from the program. The principal of the reserve will be contributed to pay off notes or credited back to the institution when the notes are converted to bonds. The interest earned on the reserve is used to pay interest due during the month. The commercial paper bears interest at a variable rate, which is paid monthly. The maturity of the paper may not exceed 270 days and the maximum interest rate may not exceed 12%. Upon maturity, the paper is redeemed or extinguished with long-term debt.

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The total indebtedness of the university at June 30, 1998, was \$299,342,185.76, and at June 30, 1997, was \$304,054,336.19.

NOTE 5. OPERATING LEASES

The university has entered into various operating leases for buildings and equipment. It is expected that in the normal course of business such leases will continue to be required. Net expenditures for rentals under leases for the years ended June 30, 1998, and June 30, 1997, amounted to \$6,554,188.17 and \$7,336,753.56, respectively.

The following is a schedule by years of future minimum rental payments required under noncancelable operating leases that have initial or remaining lease terms of more than one year at June 30, 1998.

Year Ending <u>June 30</u>	
1999	\$ 701,222.25
2000	701,222.25
2001	669,572.25
2002	599,910.16
2003	348,758.00
Later Years	<u>91,100.00</u>
Total Minimum Payments Required	<u><u>\$3,111,784.91</u></u>

NOTE 6. CAPITAL LEASE OBLIGATIONS

The university leases certain items of equipment which are classified as capital leases. These agreements have beginning and ending dates ranging from January 1996 to January 2001 and imputed interest rates ranging from 5.78% to 6.55%. Future minimum lease payments under capital leases together with the present value of the net minimum lease payments at June 30, 1998, are as follows:

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Year Ending <u>June 30</u>	
1999	\$ 666,818.10
2000	607,455.60
2001	<u>354,139.45</u>
Total minimum lease payments	1,628,413.15
Less amounts representing interest	<u>130,142.87</u>
Present value of net minimum lease payments	<u><u>\$1,498,270.28</u></u>

The total value of equipment capitalized under lease obligations was \$2,408,085.34 at June 30, 1998, and \$2,413,333.70 at June 30, 1997.

NOTE 7. INSURANCE-RELATED ACTIVITIES

Risk Management

The university is exposed to various risks of loss related to general liability; automobile liability; professional malpractice; workers' compensation; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters.

- a. The university carries commercial insurance for losses related to hired and nonowned automobiles, losses related to railroad protection, and losses related to ten university-owned aircraft. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.
- b. The state purchases commercial insurance for real property losses above \$5 million per year and surety bond coverage on the state's officials and employees. In the past three fiscal years, the state has not had any claims filed with the commercial insurer. A designation for casualty losses in the amount of \$5 million has been established in the state's general fund to provide for any property losses other than the commercial insurance coverage. At June 30, 1998, the scheduled coverage for the university was \$2,166,731,400 for buildings and \$843,227,600 for contents. At June 30,

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1997, the scheduled coverage for the university was \$2,171,421,900 for buildings and \$738,086,600 for contents.

- c. The state has set aside assets for claim settlement in an internal service fund, the Claims Award Fund. This fund services all claims for risk of loss to which the state is exposed, including general liability, automobile liability, professional malpractice, and workers' compensation. The university participates in the Claims Award Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on a percentage of the university's expected loss costs, which include both experience and exposures. This charge considers recent trends in actual claims experience of the state as a whole. An actuarial valuation is performed as of fiscal year-end to determine the fund liability and premium allocation. Since the university participates in the Claims Award Fund, it is subject to the liability limitations under the provisions of the Tennessee Claims Commission Act, *Tennessee Code Annotated*, Section 9-8-101 et seq. Liability for negligence of the university for bodily injury and property damage is limited to \$300,000 per person and \$1,000,000 per occurrence. The limits of liability under workers' compensation are set forth in *Tennessee Code Annotated*, Section 50-6-101 et seq. Claims are paid through the state's Claims Award Fund. The premium assessed to the university by the Claims Award Fund for the year ended June 30, 1998, was \$2,218,613 and for the year ended June 30, 1997, was \$8,560,900.

Employee Group Insurance

The state has also set aside assets in the Employee Group Insurance Fund, an internal service fund, to provide a program of health insurance coverage for the employees of the state with the risk retained by the state. All full-time and some part-time university employees are eligible to participate in the Employee Group Insurance Fund. The fund allocates the cost of providing claims servicing and claims payment by charging a premium to the university based on estimates of the ultimate cost of claims that have been reported but not settled and of claims that have been incurred but not reported. Employees and providers have 13 months to file medical claims. The university pays approximately 80% of the cost of insurance, and the employee pays the remaining 20%. All assets, liabilities, and payments are administered by the state. At June 30, 1998, 12,454 university employees were enrolled in the basic plan or Health Maintenance Organization. At June 30, 1997, 13,895 university employees were enrolled in the basic plan or Health Maintenance Organization.

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NOTE 8. RETIREMENT PROGRAMS

Defined Benefit Plans

During the year ended June 30, 1997, the university implemented GASB Statement 27, *Accounting for Pensions by State and Local Government Employers*. In accordance with that statement, at transition it was determined that a pension liability or asset does not exist for these plans.

Tennessee Consolidated Retirement System

Plan Description

The University of Tennessee contributes to the State Employees, Teachers, and Higher Education Employees Pension Plan (SETHEEPP), a cost-sharing multiple-employer defined benefit pension plan administered by the Tennessee Consolidated Retirement System (TCRS). TCRS provides retirement, death, and disability benefits as well as annual cost-of-living adjustments to plan members and their beneficiaries. Title 8, Chapters 34-37, *Tennessee Code Annotated*, establishes benefit provisions. State statutes are amended by the Tennessee General Assembly. The TCRS issues a publicly available financial report that includes financial statements and required supplementary information for SETHEEPP. That report may be obtained by writing to the Tennessee Department of the Treasury, Consolidated Retirement System, 10th Floor Andrew Jackson Building, Nashville, Tennessee 37243-0230 or by calling (615) 741-8202, ext. 139.

Funding Policy

Plan members are noncontributory. The university is required to contribute at an actuarially determined rate. The current rate is 3.65% of annual covered payroll. The contribution requirements of the plan members are established by state statute. Contribution requirements for the university are established and may be amended by the TCRS' Board of Trustees. The university's contributions to TCRS for the years ended June 30, 1998, 1997, and 1996 were \$8,249,822.51, \$16,639,419.22, and \$14,307,283.36, respectively. Those contributions met the required contributions for each year.

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Federal Retirement Program

Plan Description

The University of Tennessee contributes to the Federal Retirement Program, a cost-sharing multiple-employer defined benefit pension plan administered by the Civil Service Retirement System (CSRS) for participants employed prior to January 1, 1984, and the Federal Employees Retirement System (FERS) for participants employed after December 31, 1983. Both systems provide retirement, death, and disability benefits, as well as annual cost-of-living adjustments, to plan members and their beneficiaries. All regular full-time employees of the University of Tennessee Agricultural Extension Service who hold federal appointments for 51% or more of their time are required to participate in either one of the two federal retirement programs. For both systems, benefit provisions are established in federal statutes. Federal statutes are amended by the U.S. Congress.

CSRS and FERS issue publicly available financial reports that include financial statements and required supplementary information. These reports may be obtained by writing to the Office of Personnel Management, Retirement Information Office, P. O. Box 45, Boyers, Pennsylvania 16017-0045, or by calling (202) 606-0500.

Funding Policy

Participating employees, with some exceptions, and the university are required by federal statute to contribute 7% of covered payroll to the CSRS plan. Contribution requirements are established and may be amended by federal statute. Contributions to CSRS for the year ended June 30, 1998, were \$1,807,425.56, which consisted of \$993,182.54 from the university and \$814,243.02 from the employees; contributions for the year ended June 30, 1997, were \$1,750,892.38, which consisted of \$895,705.03 from the university and \$855,187.35 from the employees; and contributions for the year ended June 30, 1996, were \$1,779,920.79, which consisted of \$907,561.75 from the university and \$872,359.04 from the employees.

Federal statute requires employees participating in FERS to contribute .8% of their salaries to the Basic Benefit Plan. The university is required to contribute 10.7%. In addition, the university is required to contribute 1% of each participant's salary to the Thrift Savings Plan plus up to an additional 4% depending upon employees' contributions, which can range from 0% to 10% of their salaries. Contributions for the Basic Benefit Plan were \$884,560.16 for the year ended June 30, 1998, which consisted of \$60,638.43 from employees and \$823,921.73 from the university; \$884,462.66 for the year ended June 30, 1997, which consisted of \$57,995.03 from

The University of Tennessee
Notes to the Financial Statements (Cont.)
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employees and \$826,467.63 from the university; and \$841,226.30 for the year ended June 30, 1996, which consisted of \$55,135.25 from employees and \$786,091.05 from the university. Contributions for the Thrift Savings Plan were \$747,733.09 for the year ended June 30, 1998, which consisted of \$466,120.97 from employees and \$281,612.12 from the university; \$708,032.14 for the year ended June 30, 1997, which consisted of \$441,178.00 from employees and \$266,854.14 from the university; and \$650,769.34 for the year ended June 30, 1996, which consisted of \$402,722.00 from employees and \$248,047.34 from the university. Contributions met the requirements for each year.

Defined Contribution Plans

Optional Retirement Plans (ORP)

The university contributes to three defined contribution plans: Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), Aetna Life Insurance and Annuity Company, and Variable Annuity Life Insurance Company (VALIC). These plans are administered by the Tennessee Department of the Treasury. Each plan provides retirement benefits to faculty and staff who are exempt from the overtime provisions of the Fair Labor Standards Act and who waive membership in TCRS. Benefits depend solely on amounts contributed to the plan plus investment earnings. Plan provisions are established by state statute in Title 8, Chapter 35, Part 4, *Tennessee Code Annotated*. State statutes are amended by the Tennessee General Assembly.

Plan members are noncontributory. The university contributes an amount equal to 10% of the employee's base salary below the social security wage base and 11% above the social security wage base. Contribution requirements are established and amended by state statute. The contribution made by the university to the plans for the year ended June 30, 1998, was \$29,914,649.67, and for the year ended June 30, 1997, was \$29,845,004.14. Contributions met the requirements for each year.

Joint Contributory Retirement System Plan A - JCRS-A

The Joint Contributory Retirement System Plan A (JCRS-A) is a defined contribution plan with minimum benefits and is administered by the Tennessee Consolidated Retirement System and TIAA-CREF. Employees who were enrolled in the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) before July 1977 are members of JCRS-A. Enrollment in this plan for new employees has been closed since July 1977. Although JCRS-A members participate in Aetna,

The University of Tennessee
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TIAA-CREF, or VALIC, they may also, under certain circumstances, receive a supplementary benefit from the State of Tennessee. Plan provisions are established by *Tennessee Code Annotated*, Chapter 35, Part 4. State statutes are amended by the Tennessee General Assembly.

Plan members are noncontributory. The university's contributions for JCRS-A members were calculated using the base salary amounts of \$68,417,831.18 for fiscal year 1998 and \$73,198,878.88 for fiscal year 1997. Contribution requirements are established and amended by state statute. The contributions are included in the ORP amounts. University contributions to fund the state supplemental benefit totaled \$2,497,251.38 and \$5,380,011.15 in fiscal years 1998 and 1997. Contributions met the requirements for each year.

Deferred Compensation Plans

The University of Tennessee offers its employees three deferred compensation plans. The university, through the State of Tennessee, provides two plans, one established pursuant to *Internal Revenue Code (IRC)*, Section 457, and the other pursuant to *IRC*, Section 401(k). The third plan is administered by the university and was established in accordance with *IRC*, Section 403(b). These plans, available to all university employees, permit them to defer a portion of their salaries to future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All costs of administering and funding these plans, with the exclusion of the \$20 monthly university match for the Section 401(k) plan, are the responsibility of plan participants.

Section 457 plan balances have been reported in the State of Tennessee financial statements in an agency fund. All amounts of compensation deferred under this plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State of Tennessee (without being restricted to the provisions of benefits under the plan), subject only to claims of the state's general creditors. Participants' rights under the plan are equal to those of general creditors of the state in an amount equal to the fair value of the deferred account for each participant. It is the opinion of the state's legal counsel that the state has no liability for losses under the plan but does have the duty of due care that would be required of an ordinary prudent investor. The state believes it is unlikely that it will use these assets to satisfy such claims of general creditors in the future.

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Since Section 401(k) plan assets remain the property of the contributing employees, they are not presented in the State of Tennessee financial statements. *IRC* Section 401(k) establishes participation, contribution, and withdrawal provisions for the plan. Effective January 1996, the university began providing a \$20 monthly Section 401(k) match from unrestricted current funds for employees making a minimum monthly contribution of \$20 to the plan. During the year ended June 30, 1998, contributions totaling \$6,326,435.47 were made by employees participating in the plan, with a related match of \$1,557,590.00 made by the university.

In accordance with the *IRC*, employee contributions through the 403(b) plan remain the assets of the employee; therefore, these employee contributions are not reflected in the university's financial statements.

OTHER POST-EMPLOYMENT BENEFITS

Health care

The State of Tennessee administers a group health insurance program which provides post-employment health insurance benefits to eligible university retirees. This benefit is provided by and administered by the State of Tennessee. The university assumes no liability for retiree health care programs. Information related to this plan is available at the statewide level in the *Tennessee Comprehensive Annual Financial Report*.

NOTE 9. AFFILIATED ENTITIES

The University of Chattanooga Foundation, Inc., a private, nonprofit corporation, maintains an endowment fund of which the University of Tennessee at Chattanooga is the sole income beneficiary. The financial records, investments, and other financial transactions are not managed by the university and accordingly are not included in these financial statements except for certain endowment assets. During the years ended June 30, 1998, and June 30, 1997, the Foundation transferred \$2,475,201.00 and \$2,479,814.00, respectively, to the university for support of designated projects at the Chattanooga campus. In addition, \$94,584.13 and \$115,150.41 were expended in 1998 and 1997 directly by the Foundation for the benefit of the University of Tennessee at Chattanooga.

Since fiscal year 1985, the Tennessee General Assembly has appropriated \$22 million to a Chairs of Excellence Endowment for the University of Tennessee. The appropriations provided that the Chairs of Excellence Endowment be established as an

The University of Tennessee
Notes to the Financial Statements (Cont.)
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irrevocable trust with the state treasurer and required the university to match the appropriation on a dollar-for-dollar basis. The university has fully matched 49 chairs as of June 30, 1998. The financial statements of the university include as restricted expenditures the amounts expended in the current year to match the state appropriations. The university's balance sheets do not include the amounts held in trust by the state treasurer.

NOTE 10. CONTINGENCIES AND COMMITMENTS

Construction Commitment

The university has contractual obligations for the construction of new buildings and additions to and renovations of existing buildings. The outstanding commitments under such contracts at June 30, 1998, were \$31,605,631.81. At June 30, 1997, these commitments were \$22,478,119.19. At June 30, 1998, amounts due from or receivable from the state totaled \$44,468,206.16, and amounts due from or receivable from the School Bond Authority for capital construction, renovations, and maintenance totaled \$3,452,900.81. At June 30, 1997, these amounts totaled \$47,545,253.13 and \$3,500,505.79.

Construction in Progress

Construction in progress is included in buildings and improvements other than buildings in investment in plant. Fifty-five projects were under construction at June 30, 1998, and 51 were under construction at June 30, 1997. Construction in progress totaled \$45,786,374.95 at June 30, 1998, and \$51,037,430.46 at June 30, 1997.

Encumbrances

Encumbrances which represent commitments of prior-year funds for goods that have been ordered but not delivered or services that have not been rendered as of June 30, 1998, are recorded as an allocation of the current fund balances. The allocation for encumbrances at June 30, 1998, was \$10,743,210.30. The allocation for encumbrances at June 30, 1997, was \$8,939,235.95.

Sick Leave

The university's policy is to record the cost of sick leave when paid. Generally, since sick leave (earned one day per month with unlimited accumulation) is paid only when an employee dies or is absent due to illness, or injury, there is no liability for sick leave

The University of Tennessee
Notes to the Financial Statements (Cont.)
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at June 30, 1998. The amount of unused sick leave at June 30, 1998, was \$159,572,478.32 and at June 30, 1997, was \$153,883,556.38.

Grants and Contracts

The university receives grants and contracts from various federal and state agencies to fund research and other activities. The costs, both direct and indirect, charged to these grants and contracts are subject to audit and disallowance by the granting agency. The university administration believes that any disallowance or adjustments would not have a material effect on the university's financial position.

Nonvested Equipment

Equipment in the possession of the university valued at \$7,966,857.16 and \$8,288,627.86 as of June 30, 1998, and June 30, 1997, respectively, is not reflected in the financial statements. This equipment was purchased with restricted grant and contract funds and other funds, and title has not yet transferred to the university.

Litigation

Various litigation has arisen in the course of conducting university business. The outcome of such litigation is not expected to have a material effect on the financial position of the university.

NOTE 11. PLEDGES

Pledges totaling \$31,789,092.85, restricted to instruction, research, public service, library, operation and maintenance of physical plant, student aid, property, buildings, equipment, endowment, loans, and other restricted purposes, are due to be collected over the next five fiscal years as follows:

<u>Fiscal Year</u>	
1998-99	\$ 9,139,469.25
1999-2000	9,756,514.67
2000-01	5,602,593.95
2001-02	4,156,142.78
2002-03	<u>3,134,372.20</u>
Total	<u>\$31,789,092.85</u>

The University of Tennessee
Notes to the Financial Statements (Cont.)
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It is not practicable to estimate the net realizable value of such pledges, and therefore, they are not reflected in the accompanying financial statements.

NOTE 12. YEAR-2000 RESOURCES COMMITTED

Ensuring that the university's administrative computing systems are fully operational and functional into the Year 2000 (Y2K) and beyond is of critical importance to the university. The problem was recognized early, and an assessment of university systems began in 1996 and continued through early 1997.

Remediation efforts on university-wide administration (UWA) systems began in April 1997, with 123 major UWA systems and subsystems identified as needing changes. By the end of fiscal year 1998, 75 UWA systems (61%) were deemed Y2K compliant, satisfactorily tested and returned to production. The university administration maintains, and it is reasonable to expect, that all UWA systems will be Y2K compliant by the end of fiscal year 1999.

During fiscal year 1998, approximately \$1,514,000 was spent on the Y2K compliance effort for UWA systems. These expenditures include the cost of UWA staff assigned to the effort, contract programming support, and required software and hardware upgrades. The projected cost of UWA systems Y2K compliance efforts during fiscal year 1999 is approximately \$953,000.

UWA systems comprise the business-related systems of the university: general ledger, procurement, human resources, and budget. Campus administrative systems are those related to students: recruitment, admissions, registration, scheduling, accounts receivable, and grades. The university is equally concerned with the Y2K compliance of these systems.

Although data is less definitive, the university's campuses reported minimum expenditures of approximately \$430,000 during fiscal year 1998 on issues related to Y2K compliance. The Y2K compliance strategy of three of the four primary campuses is to buy replacement software, charging a portion of that cost to Y2K compliance. Some cost, however, was still directly attributable to remediating and testing legacy systems for Y2K compliance. The minimum campus expenditure for Y2K compliance in fiscal year 1999 is projected to be approximately \$120,000.

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Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

NOTE 13. PRIOR-PERIOD RESTATEMENTS

For the year ended June 30, 1998, certain fund balances and amounts held in custody for others in the university's agency fund were restated as follows:

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Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

	Current Funds						
	Unrestricted						
	Educational and General	Auxiliary Enterprises	Hospitals	Restricted	Loan Funds	Endowment and Similar Funds	Life Income Funds
Fund balances/deposits held for others at July 1, 1997, as previously reported	\$43,422,707.19	\$11,190,167.10	\$75,205,521.26	\$77,663,897.62	\$36,762,646.27	\$226,485,972.48	\$36,918,078.88
To reflect adoption of GASB 31, <i>Accounting and Financial Reporting for Certain Investments and for External Investment Pools</i>	260,274.54	51,955.66	71,598.64	100,165.08	17,654.47	54,789,251.20	1,418,882.68
To reflect implementation of GASB 16, <i>Accounting for Compensated Absences</i>	(38,276,983.25)	(2,022,078.95)	(9,349,404.69)	-	-	-	-
To correct the presentation of the accretion of TSSBA College Savers Bonds	-	-	-	-	-	-	-
To correct the presentation of accrued interest on endowment funds	-	-	-	1,304,415.00	-	-	-
To reflect a change in accounting policy—netting Assets with Trustee—TSSBA with TSSBA indebtedness	-	-	-	-	-	-	-
Fund balance adjustments	<u>(38,016,708.71)</u>	<u>(1,970,123.29)</u>	<u>(9,277,806.05)</u>	<u>1,404,580.08</u>	<u>17,654.47</u>	<u>54,789,251.20</u>	<u>1,418,882.68</u>
Fund balances at July 1, 1997 as restated	<u>\$ 5,405,998.48</u>	<u>\$ 9,220,043.81</u>	<u>\$65,927,715.21</u>	<u>\$79,068,477.70</u>	<u>\$36,780,300.74</u>	<u>\$281,275,223.68</u>	<u>\$38,336,961.56</u>

The University of Tennessee
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For the year ended June 30, 1998, the university implemented Governmental Accounting Standards Board (GASB) Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which requires reporting investments with a remaining maturity of more than one year at the time of purchase at fair value. The cumulative effect of this change in accounting principle is reported in the accompanying financial statements as an increase to beginning fund balances and deposits held for others of \$57,777,919.96.

For the year ended June 30, 1998, the university implemented GASB No. 16, *Accounting for Compensated Absences*, which requires the recognition of a liability for compensated absences for which certain staff will be paid. The cumulative effect of adopting this statement is reported in the accompanying financial statements as a decrease to beginning fund balances of \$49,648,466.89.

For the year ended June 30, 1998, the university changed its method of accounting to reflect the accretion of Tennessee State School Bond Authority (TSSBA) College Savers Bonds. The cumulative effect of this correction is reported in the accompanying financial statements as an increase in the value of the bonds and a decrease in beginning investment in plant of \$8,464,845.36.

For the year ended June 30, 1998, the university changed its method for recording accrued interest on endowment funds. The university had previously recorded endowment income on a cash basis. The cumulative effect of this correction is reported in the accompanying financial statements as an increase to the restricted current funds beginning fund balance of \$1,304,415.00.

For the year ended June 30, 1998, the university changed its accounting policy to offset "Tennessee State School Bond Authority indebtedness" with "assets with trustee - Tennessee State School Bond Authority" in the investment in plant fund. The university had previously reported these assets in retirement of indebtedness with a corresponding restricted fund balance. The cumulative effect of this change in accounting policy is reported in the accompanying financial statements as a decrease to beginning retirement of indebtedness fund balance of \$29,529,541.03 and an increase in beginning investment in plant of \$29,529,541.03.

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June 30, 1998, and June 30, 1997

NOTE 14. SUBSEQUENT EVENTS

UT Memorial Research Center and Hospital

At the June 18, 1998, university board meeting, the Board of Trustees authorized the university administration to take necessary steps to create a separate not-for-profit corporation, tax exempt under Section 501 (c) (3) of the *Internal Revenue Code*, for the purpose of restructuring the operation, maintenance, and governance of the University of Tennessee Memorial Research Center and Hospital. All plans shall be approved by the Board of Trustees, the State Attorney General, and the State Building Commission. The new corporation is expected to commence operations July 1, 1999.

Bond Issue

On October 1, 1998, the Tennessee State School Bond Authority will issue 1998 Series B, C, and D bonds. The Series B bonds will refund approximately \$2.3 million of the university's taxable commercial paper and refinance the university's stadium project in Chattanooga. Series C will provide tax-exempt funds to completely refund the Series 1972, 1977, 1977R, and 1985 bonds. The Series D will provide tax-exempt funds to complete an economic defeasance of the Series 1992 bonds currently outstanding. The new Higher Educational Facilities Second Program General Bond Resolution will govern the sale of all of the above bonds. Specific debt service reserve funds for refunded bonds may be spent to downsize the refunding bonds. However, this will happen only if a debt service surety bond is purchased as a substitute for the debt service reserve fund as stated in the Higher Educational Facilities Second Program General Bond Resolution. The sale of Series B occurred on September 10, 1998, at competitive sale. Series C and D bonds were sold at negotiated sale on September 24, 1998. Additionally, the University of Tennessee Memorial Hospital projects in the refunded bond issues will be refunded into taxable commercial paper to facilitate the expected conversion of the hospital to an independent 501(c)(3) institution in approximately 12 months.

NOTE 15. COMPONENT UNIT CONDENSED FINANCIAL STATEMENTS

The financial statements include a discrete presentation of the assets, liabilities, fund balances, revenues, and expenses of the University Health System, Inc., for the years ended December 31, 1997, and December 31, 1996. This information is also presented on the following pages, along with the corporation's Statement of Cash Flows.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

The corporation is a separately incorporated entity, and its financial statements are examined by other auditors. The condensed financial statements below are based solely upon the report of other auditors and the management of the corporation.

BALANCE SHEET

	December 31, 1997	December 31, 1996
<u>ASSETS</u>		
Amounts receivable from the university	\$ 466,405	\$ 727,365
Other current assets	5,898,869	12,997,138
Other assets	1,599,371	2,221,010
TOTAL ASSETS	<u>\$ 7,964,645</u>	<u>\$ 15,945,513</u>
<u>LIABILITIES AND NET WORTH</u>		
Current liabilities due to the university	\$ 480,859	\$ 3,348,568
Funds held in trust for the university	3,506,337	8,816,017
Other current liabilities	1,143,331	1,789,818
Net worth	2,834,118	1,991,110
TOTAL LIABILITIES AND NET WORTH	<u>\$ 7,964,645</u>	<u>\$ 15,945,513</u>

See notes to financial statements.

STATEMENT OF REVENUES AND EXPENSES

	1997	1996
<u>REVENUES</u>		
Gain from settlement with the university	\$ 1,055,355	\$ -
Other university related revenues	1,735,994	1,624,301
Other revenues	3,444,844	1,633,571
TOTAL REVENUES	<u>6,236,193</u>	<u>3,257,872</u>
<u>EXPENSES</u>		
University related	413,841	316,715
Depreciation	108,807	241,120
Other	4,870,537	2,653,512
TOTAL EXPENSES	<u>5,393,185</u>	<u>3,211,347</u>
NET INCOME (LOSS)	<u>\$ 843,008</u>	<u>\$ 46,525</u>

See notes to financial statements.

The University of Tennessee
Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

STATEMENT OF CASH FLOWS

	1997	1996
Cash flows from operating activities:		
Net income	\$ 843,008	\$ 46,525
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	164,233	100,774
Equity in (income) loss of affiliate	(481,633)	27,768
Increase (decrease) in receivables	27,943	(447,126)
Increase in prepaid expenses	(18,558)	(44,894)
Decrease in intangible assets	-	677,990
Decrease in accounts payable and accrued expenses	(2,920,106)	(3,384,454)
(Decrease) increase in deferred revenue	(536,747)	1,212,946
(Decrease) increase in income taxes payable	(20,626)	26,227
Net cash used in operating activities	(2,942,486)	(1,784,244)
Cash flows from investing activities:		
Maturities of short-term investments	-	49,015
Additions to property and equipment	(98,147)	(307,830)
Disposal of property and equipment	469	-
Investment in affiliated company	-	(1,674,786)
Net cash used in investing activities	(97,678)	(1,933,601)
Cash flows from financing activities:		
Capital contributions from UT Health Plan, Inc.	-	3,968,777
Capital contributions from University of Tennessee	-	3,802,285
Cash received for University of Tennessee Medical Center	26,895,073	13,040,482
Cash disbursed for University of Tennessee Medical Center	(32,204,753)	(4,224,465)
Net cash provided by (used in) financing activities	(5,309,680)	16,587,079
Net increase (decrease) in cash and cash equivalents	(8,349,844)	12,869,234
Cash and cash equivalents at beginning of year	12,869,234	-
Cash and cash equivalents at end of year	\$ 4,519,390	\$ 12,869,234
See notes to financial statements.		

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Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

Summary of Significant Accounting Policies

Basis of financial statement presentation

The financial statements for the University Health System, Inc. (UHS, Inc.) are prepared in accordance with generally accepted accounting principles as prescribed by the Financial Accounting Standards Board. The financial statements include the accounts of the corporation and its wholly owned subsidiary, Managed Care Ventures I, Inc. Intercompany transactions and accounts have been eliminated in the financial statements.

Nature of Business

University Health System, Inc. (UHS, Inc.) was formed on January 1, 1996, for the purpose of providing practice management and other administrative services to physicians groups, physicians associations, and the University of Tennessee Medical Center at Knoxville. Substantially all of the corporation's revenues and resulting receivables are derived from these services which are provided to organizations located in East Tennessee.

Related Parties

UHS, Inc. is wholly owned by the University of Tennessee and is affiliated through a brother/sister relationship with the University of Tennessee Medical Center at Knoxville. UHS, Inc. provides administrative services to the University of Tennessee Medical Center. The contractual services amounted to \$347,676 in 1997 and \$166,950 in 1996.

UHS, Inc. owns 100 percent of Managed Care Ventures I, Inc., which in turn owns 50 percent of Tennessee Health Partnership. In addition, UHS, Inc. provides administrative services for University Physicians Association. The Association paid University Health Systems, Inc. \$276,492 in 1997 and \$247,518 in 1996 for administrative services. The principal source of revenue for University Physicians Association is a capitated health care contract with Tennessee Health Partnership.

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Notes to the Financial Statements (Cont.)
June 30, 1998, and June 30, 1997

Investment in Affiliated Company

The corporation owns 50% of Tennessee Health Partnership and accounts for the investment using the equity method. The corporation's investment is increased for contributions to capital and its respective share of the investee's earnings. The investment is decreased for dividends received and the corporation's respective share of losses. The carrying value of the investment approximates the related equity in the net assets of the investee. The summary financial information is excerpted from audited financial statements.

Balance Sheet	<u>1997</u>	<u>1996</u>
Current assets	\$ 23,163,003	\$ 22,626,637
Other assets	345,139	418,918
Property and equipment	<u>685,910</u>	<u>574,496</u>
	<u>\$ 24,194,052</u>	<u>\$ 23,620,051</u>
Current liabilities	\$ 21,815,484	\$ 20,267,056
Other liabilities	103,108	40,798
Partner's capital	<u>2,275,460</u>	<u>3,312,197</u>
	<u>\$ 24,194,052</u>	<u>\$ 23,620,051</u>
Results of Operations		
Revenue	\$ 150,569,714	\$ 101,339,695
Less:		
Expenses	148,997,238	101,105,827
Income taxes	<u>609,213</u>	<u>66,540</u>
Net Income	<u>\$ 963,263</u>	<u>\$ 167,328</u>